3.05 Investments in the Stock of Other Entities

Overview

An investor may acquire equity securities (common or preferred stock), debt securities (bonds), and derivatives (eg, stock rights) of other companies. When a company acquires equity securities of another entity, they are generally reported on the balance sheet at their *fair market values* as of the balance sheet date, with both realized and unrealized gains/losses being reported in *income*.

As indicated previously, however, there are three circumstances that either require or allow a different accounting treatment.

0 – 20% Adjusted cost method*	20 – 50% Equity method (one-line consolidation)	50% + Consolidation (another section)
• Investor cannot exercise significant influence over investee. • Used when fair value is not readily determinable. • Requires election.	• Investor can exercise significant influence over the entity. • Investor does not have a controlling financial interest.	• Investor has a controlling financial interest in the investee (Acquiree). • May result from equity ownership or other factors, such as representation on the BOD, making the investor the primary beneficiary of a VIE.

**There is no longer an official term for the accounting for these types of investments. "Adjusted cost method" is used for the sake of convenience.*

Equity Method

The equity method is used when the investor can exercise significant influence over the operating and financial policies of the investee. This method is more consistent with accrual accounting in that the investor recognizes its share of the investee's income in the period earned, regardless of if or when the income is distributed to equity holders. (ASC 323)

It is generally assumed that the investor has such ability when it holds 20% or more of the voting equity stock, but that is not required. When ownership is less than 20%, the degree of influence held by the investor is a matter of professional judgment and considers various factors:

- Significant intercompany transactions, or technological dependency.
- Officers of the investor serving as officers or board members of the investee.
- The investor is a major customer or supplier of the investee
- The investor owns at least 20% of the voting stock of the investee provided:
  - No other investor holds a larger voting block, or
  - A small group of investors own a majority of the equity and exercises total control.

- The investor has definite plans to acquire additional stock in the future to bring their interest up to at least 20%.

When applying the equity method:

- The investment is originally recorded at Cost
- As the investee reports earnings, it is reported on the investor's income statement as "equity in earnings," equal to the investor's percentage owned multiplied by the investee's earnings, as a component of continuing operations.
  - Similar to consolidated financial statements, the effects of intercompany transactions are eliminated.
  - The investor increases the investment by the same amount.
- If the investee reports losses, the entity will recognize its share of the losses in earnings as "equity in losses," reducing the investment by the same amount.
  - In general, losses cannot be recognized that reduce the carrying value of the investment below zero, unless the investor has guaranteed investee obligations or is committed to provide additional financial support.
  - If the investee subsequently becomes profitable again, unrecognized equity method losses will be offset against the investor's share of profits until they have been absorbed.
- Dividends received are considered a reduction of the investment account and do NOT appear on the income statement. The assumption is that the investor already recorded its share of the investee's income prior to its being distributed in the form of dividends.
- When the purchase price is not equal to the investor's percentage owned multiplied by the investee's book value, adjustments to equity in earnings will result in order to reflect the investor's true share of the investee's income.
  - Those differences are considered:
    - Fair value write up of assets (Fair value increment)
      - PP&E – depreciated
      - Inventory – written off when sold
      - Land – not depreciated but written off when sold
      - Goodwill – not amortized but impairment losses recognized

Ownership of preferred stock cannot, by itself, give an investor significant influence. However, the investor may have such influence due to other causes and, thus, may use the equity method of accounting for the preferred stock investment.

Preferred stock income under the equity method is equal to the dividends allocated to it.

- For noncumulative preferred stock, this will equal declared dividends only.
- For cumulative preferred stock, this will equal the annual dividend preference regardless of payments in that year.

To illustrate the accounting under the equity method, assume an investor paid $300 on 1/1/X1 to acquire 30% of the stock of an investee, at a time when the investee's net assets (equity) equaled $1,000. As a result, the original investment equaled the investor's 30% share of equity.

In 20X1, the investee reported net income of $400 and paid dividends totaling $100 to stockholders of record on 12/31/X1 with a payment date of 1/7/X2. The investment entry is:

1/1/X1		
Investment	300	
Cash		300

The entry to report the investor's share of income is:

12/31/X1		
Investment	120	
Equity in investee income		120

The entry to record the dividend:

12/31/X1		
Dividends receivable	30	
Investment		30

There is also an entry on 1/7/X2 for the collection of the receivable. Notice that the investor's investment account changes as the equity of the investee changes.

	S/E of Investee	Investment (30%)
Purchase Date, 1/1/X1	$1,000	$300
Net Income	400	120
Dividends	(100)	(30)
Balance, 12/31/X1	1,300	390

In the example, the $300 purchase price equaled 30% of the equity of the investee. When the purchase price exceeds the investor's share of equity, the excess needs to be identified, and accounted for in an appropriate manner. First, any assets with fair values differing from carrying values are identified, and the investor determines their percentage share of that excess (or deficiency). Any remaining excess is assumed to represent goodwill on the purchase.

The excess of the cost of the investment over book value is not reported separately on the financial statement; it is included in the investment. Nevertheless, it will have an impact on the

subsequent reporting of income by the investor that depends on the nature of the asset causing the difference:

- Depreciable and amortizable assets – Differences will be amortized against the reported equity in investee income based on the appropriate life of the asset.
- Goodwill – Amount initially recorded will later reduce reported income in periods in which impairment losses are recognized. If the alternative accounting approach for nonpublic entities is elected, it is amortized.
- All assets – Outstanding differences will be written off against reported income at the time the asset is sold or otherwise disposed of.

These adjustments are necessary for reporting the investor's true share of the investee's earnings.

For example, an equity method investee may have a building that had a book value of $50,000 when the investor acquired its shares. However, if the fair value of the building was greater, say $1,000,000 on that date, the value, and therefore the purchase price of the shares, would include the $1,000,000 amount, not the $50,000.

When the investee is depreciating the building, its depreciation expense will be based on the book value of $50,000. The investor, on the other hand, is paid the equivalent of its share of $1,000,000 and has to depreciate the difference.

Assume the investor's 30% investment in the previous example cost $380 instead of $300; that $10 of the excess was attributable to inventory, which was sold during 20X1; $30 was attributable to land, which was still owned by the investee at the end of 20X1; and the remaining $40 represented a building, with an estimated useful life of 40 years.

The inventory excess should be written off in 20X1, the land excess should remain, and building depreciation of $40 / 40 = $1 should be recorded in 20X1. As a result, the equity in investee income reported by the investor is $109, computed as follows:

Net income of investee	400
Percentage	30%
Investor share	120
Inventory	(10)
Land	(0)
Building	(1)
Equity in investee income	109

Examine the changes in the investment account in 20X1, in comparison to the changes in the investor's share of the investee's equity:

	S/E of Investee	Investment (30%)	Equity (30%)	Excess
Purchase Date, 1/1/X1	$1,000	$380	$300	$80
Net Income	400	109	120	(11)
Dividends	(100)	(30)	(30)	-----
Balance, 12/31/X1	$1,300	$459	$390	$69

By including the adjustments for the sale of inventory and depreciation on the building in income, the excess of cost over book value in the initial investment is gradually being written off. After the land is sold by the investee and building is completely depreciated, the investment will equal equity, and further reported income will simply be the investor's ownership percentage multiplied by the investee's reported income.

On 1/1/X1, we acquire 30% of a company for $1,000. The fair value (FV) of the investee is $3,000 and the book value (BV) is $2,500. The difference is from PP&E with an FV $500 higher than its BV. During the year, the investee reports income of $120 and pays dividends of $40. PP&E is depreciated over 10 years, and 10% of initial goodwill (GW) is impaired that year.

A significant amount of research was performed, and experts were consulted, to assist in the measurement of the FV of the entity to enable a reasonable purchase price. Generally, however, the FV of this investment is not readily determinable and there were no observable market transactions involving the security during the period X1.

In addition, reviewing all relevant information, there were no indications that the investment was impaired or that the investee would have a substantial doubt as to its ability to continue as a going concern.

Investee's balances at 1/1/X1	FV	$3,000 / Investee's income is $120 / GW impaired by 10%
	BV	$2,500 / Dividend paid is $40

Purchase price	$1,000	$100 Goodwill—impaired by $10	
FV of investor's share of investee	$900 (3,000 × 30%)		
BV of investor's share of investee	$750 (2,500 × 30%)	$150 FV PP&E / 10 yrs =	$15 yr
			$25

The journal entries under the Equity method would be:

1. Record acquisition of investment at cost

Investment	$1,000		($750 BV + $150 PP&E + $100 GW)
Cash		$1,000	

2. Record % of earnings ($120 annual income × 30% = $36)

Investment	$36	
Equity in earnings (I/S)		$36

3. Record % of Cash dividend ($40 dividend received × 30% = $12)

Cash	$12	
Investment		$12

4. Record amortization/depreciation/impairment of excess between purchase price & BV

Equity in earnings (I/S)	$25		($10 GW + $15 PP&E)
Investment		$25	

Investment T-account	
1,000	
36	
	12
	25
999	

Note: The investment account changes as the investee's equity account changes (better accrual accounting).